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TAGS: PGOV PREL PINR MX
SUBJECT: MEXICO'S ECONOMIC OUTLOOK IMPROVES SLIGHTLY;
CONCERNS REMAIN

REF: MEXICO 2537

Summary

1.(U) While recent data shows encouraging news for the Mexican economy, many observers recognize that other less positive elements prevail that could materialize into a weaker economy. Recent positive data includes increased consumer confidence, retail sales, purchaser manufacturing indexes, as well as oil prices. Many economists have revised upward their 2009 and 2010 growth forecasts. In his annual "State of the Union" speech, President Calderon signaled that he plans to pursue a relatively ambitious agenda, despite his party having been weakened in Congress as a result of the mid-term elections. In the speech, the President indicated that the recession had touched bottom, and presented his plans for continued economic reforms and proposals for increasing the country's competitiveness. As negotiations over the 2010 budget proceed in Congress, and both branches of government examine possible solutions to Mexico's public finance challenges and anemic growth, analysts say the economy could still exhibit some further downside trends that might threaten the otherwise improved outlook. Analysts point to the continued dependence on oil revenues, the negative impact of expenditure cuts (particularly on infrastructure), the likelihood of suboptimal solutions to much needed tax reform/increased tax revenues, and the new dominance (and highly politicized actions) of the opposition PRI in Congress as elements which could weaken the economy. End Summary.

Slightly Improved Outlook

¶2. (U) In light of the latest global and domestic economic indicators, many analysts are now forecasting slightly more optimistic trends for the Mexican economy in 2010. The outlook improves because of the U.S. recovery, alongside better-than-expected data for key domestic indicators, such as consumer confidence, retail sales, purchaser manufacturing indexes, etc. Oil prices, a key commodity for Mexico, have also been strengthening as of late. The central bank's August survey of economists indicates a higher GDP growth forecast of 2.9 percent (from 2.5). HSBC has also revised their growth estimate for 2010 to 3.6 percent (from 2.9). Likewise, Banamex projects 3.6% growth.

Concerns Remain

¶3. (SBU) Nevertheless, while recent information shows encouraging news, other less positive elements prevail that could generate a weaker economy. Some of the points of concern raised by economic/market analysts include:

-- The PRI's increased congressional presence and higher profile at the state level (PRI holds 19 of 32 governorships) following the July midterm elections puts the GOM and the PAN in a weaker position going into budget negotiations this fall. The markets perceive the PRI as reluctant to pass any significant tax reform or subsidy reductions. Moreover, the PRI will try to secure a larger share of the federal budget going to state and local governments in advance of ten gubernatorial races in 2010 and the 2012 presidential elections, which could deprive the federal government of resources for social expenditures. State finances are also generally perceived as lacking in adequate accountability measures. A well-connected Mexican analyst told econoffs the PRI will likely push for a lower benchmark oil mix price, sending a greater portion of the resulting surplus to states for discretionary spending.

-- High dependency on oil revenues continues. Approximately 35-40 percent of total revenues come from petroleum sales. The combination of lower-than-anticipated oil production, a biased tax structure, an overblown bureaucratic structure, and important subsidy expenditures, have resulted in fiscal

deterioration. (See reftel.)

-- This deterioration has prompted the urgency for additionally revenues and cutting expenditures. Most analysts anticipate the likelihood of an increased deficit in the 2010 budget of between 2 and 4 percent of GDP. Note: About an additional 1.2 percent of GDP is an off-budget deficit (long-term infrastructure debt, debt from the 1995 financial bailout, and pension obligations). End Note.

-- With respect to higher revenues, the prevailing view is that substantive fiscal reform is not viable and suboptimal solutions will likely be adopted. (Septel on prospects for fiscal reform.)

-- There is speculation that increased revenues may be generated from price increases in goods and services provided or controlled by the public sector, particularly in gasoline and diesel prices. There have already been some price increases in high-end consumer electricity tariffs and highway tolls. There is more uncertainty regarding changes in income taxes or the VAT.

GOM Response

¶4. (U) On September 2, President Calderon offered proposals to boost growth and shore up the fiscal accounts in its annual "state of the union" speech. Without providing many details, Calderon unveiled a 10-point plan to "transform" Mexico. On the fiscal front, the plan would include expenditure cuts, tackling tax evasion and broadening the tax base. Of note, he said his budget proposal would seek to free up funds for social spending by reducing outlays on bureaucracy and that a second new oil-sector reform was necessary. (Comment: Aside from any change to inefficient oil and electricity parastatals Pemex and CFE, this may be referring to the intention of the Finance Secretariat to make the fuel pricing structure more flexible as part of the tax reform. End Comment.) Other proposals include universal health care, education, labor reform, enhanced competition in telecoms, and expanding the war on crime and political reform (septel). Calderon added that only a comprehensive fiscal or energy reform would translate into an improvement in Mexico's

credit outlook.

Opposition Response

¶5. (U) Meanwhile, on September 2 the PRI presented to Congress their own plan to reactivate the economy which included proposals to "re-consolidate the development banks," cut expenditures (mainly at the federal level) and a revision of the so-called special regimes (loopholes, subsidies) which currently represent an estimated 3.9 percentage points of GDP in foregone revenue; the PRI reiterated that it will not support broadening the VAT to include food and medicine.

Comment

¶6. (SBU) As negotiations proceed in Congress, further concerns -- outlined in paragraph 3 -- could develop. This could present a significant downside risk to an otherwise improved outlook. Calderon has signaled that he plans to pursue a relatively ambitious economic and social agenda, despite his party being weakened in Congress. While the PRI may be willing to broker deals with the GOM, 2012 electoral considerations mean they are unlikely to support extensive fiscal and energy reform moves. Most immediately, they may well seek to drive or obstruct the 2010 budget legislation, which is likely to include plans to increase tax collection and debt, and cut spending. If the PRI succeeds in their pursuit of obtaining more federal transfers, the GOM may weaken politically, as they will have fewer resources under their control for social expenditure. Other serious considerations to keep in mind include inflationary pressures caused by GOM price hikes and market reactions to anticipated

cabinet changes, including Finance, Economy, as well as the Central Bank.
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